

Dishonesty and Profit Exclusions Preclude Coverage for Insured After Criminal Conviction

July 2006

In an unreported decision, the United States District Court for the District of Kansas, applying Kansas law, granted an insurer's motion for summary judgment, holding that coverage was precluded under a D&O policy because the insured was found guilty of deliberately committing fraudulent or dishonest acts and because the insured was found guilty of obtaining personal profit or advantage to which he was not legally entitled. *Ary v. Cincinnati Ins. Co.*, 2006 WL 1360095 (D. Kan. May 17, 2006).

The insurer issued a D&O policy to two related foundations. The policy contained an exclusion providing that the insurer is not "liable to pay, indemnify, or defend any 'claim'" related to "any deliberately fraudulent, dishonest, criminal or malicious act or omission." A second exclusion stated the insurer was "not liable to pay, indemnify or defend any 'claim' of an insured related to 'any personal profit or advantage' to which he is 'not legally entitled.'"

In the underlying action, the chief executive officer (CEO) of the foundations was indicted and convicted of violating various federal criminal statutes through his scheme to "defraud and obtain money by means of false and fraudulent pretenses and representations . . . in relation to online auction sales of property belonging to [the foundation] or the government." The CEO sought coverage under the policy for the criminal action brought against him. The insurer denied coverage, arguing that the exclusions for criminal acts and personal profit precluded coverage. Coverage litigation ensued.

The court first observed that it was faced with the issue of how a verdict affects an insurer's interpretation of its policy where, as here, the insurer initially denied coverage prior to the verdict. The court determined that the focus of its inquiry should be the language of the policy and the "[CEO's] status before the return of the jury verdict."

Looking at pretrial coverage under the policy, the court recognized that the CEO was considered an "insured," the criminal action constituted a "claim" and the costs related to defending the action constituted a "loss." The court then emphasized that because a "wrongful act" under the policy included "any actual or alleged error" that was "attempted or allegedly committed" by an insured, the CEO's acts may have been considered an

"alleged error" before the time of trial because the CEO had pled not guilty to the charges. Similarly, under the policy exclusions, the court noted that "before trial it was not clear whether [the CEO] had committed deliberate fraud or gained personal profit." The court held that absence of "final adjudication" language in the exclusions did not require a different result because the lack of the phrase "makes it more ambiguous when the insurer may conclude that an exclusion applies." Therefore, the court concluded that the CEO may have been entitled to coverage before the verdict.

However, the court recognized that the pre-conviction facts were less important than the facts as presented to the court post-conviction. The court noted that "the duty to defend is measured from the beginning of the action," but "courts have acknowledged that subsequent factors may be taken into consideration." The court explained that there was no case law from Kansas or the United States Court of Appeals for the Tenth Circuit to suggest the proper way to approach a policy in such circumstances. Relying on the language of the federal criminal statutes that the CEO was convicted of violating, the court reasoned that "the very language of these statutes emphasizes fraud and dishonesty as elements of commissioning the crime." Therefore, the court held the exclusion prohibiting deliberately fraudulent or dishonest conduct precluded coverage under the policy following the jury verdict. Moreover, the court held that the second exclusion also precluded coverage because the CEO received profits from sales of foundation property to which he was not entitled and was found guilty of depositing checks from auction sales to his personal accounts.